CENTURYLINK, INC
Form 10-Q
August 04, 2016

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

ý QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2016
or
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to
Commission File No. 001-7784

CENTURYLINK, INC.
(Exact name of registrant as specified in its charter)

Louisiana (State or other jurisdiction of incorporation or organization)	72-0651161 (I.R.S. Employer Identification No.)
100 CenturyLink Drive, Monroe, Louisiana (Address of principal executive offices)	71203 (Zip Code)

(318) 388-9000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ý No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer ý	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes o No ý

On July 28, 2016, there were 545,969,547 shares of common stock outstanding.

TABLE OF CONTENTS

* All references to "Notes" in this quarterly report refer to these Notes to Consolidated Financial Statements.

PART I—FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS
CENTURYLINK, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended June 30, 2016	Three Months Ended June 30, 2015	Six Months Ended June 30, 2016	Six Months Ended June 30, 2015
	(Dollars in millions, except per share amounts and shares in thousands)			
OPERATING REVENUES	$4,398	4,419	8,799	8,870
OPERATING EXPENSES				
Cost of services and products (exclusive of depreciation and amortization)	1,949	1,959	3,849	3,870
Selling, general and administrative	812	863	1,643	1,714
Depreciation and amortization	987	1,048	1,963	2,088
Total operating expenses	3,748	3,870	7,455	7,672
OPERATING INCOME	650	549	1,344	1,198
OTHER (EXPENSE) INCOME				
Interest expense	(340)	(327)	(671)	(655)
Other income, net	7	12	24	14
Total other expense, net	(333)	(315)	(647)	(641)
INCOME BEFORE INCOME TAX EXPENSE	317	234	697	557
Income tax expense	121	91	265	222
NET INCOME	$196	143	432	335
BASIC AND DILUTED EARNINGS PER COMMON SHARE				
BASIC	$0.36	0.26	0.80	0.60
DILUTED	$0.36	0.26	0.80	0.60
DIVIDENDS DECLARED PER COMMON SHARE	$0.54	0.54	1.08	1.08
WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING				
BASIC	539,627	558,640	539,213	560,304
DILUTED	540,375	559,220	540,281	561,362

See accompanying notes to consolidated financial statements.

CENTURYLINK, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(UNAUDITED)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(Dollars in millions)			
NET INCOME	$196	143	432	335
OTHER COMPREHENSIVE INCOME:				
Items related to employee benefit plans:				
Change in net actuarial loss, net of $(17), $(15), $(33) and $(30) tax	28	27	54	50
Change in net prior service costs, net of $(1), $(3), $(2) and $(5) tax	2	4	4	8
Foreign currency translation adjustment and other, net of $—, $—, $— and $— tax	(4)	11	(5)	—
Other comprehensive income	26	42	53	58
COMPREHENSIVE INCOME	$222	185	485	393

See accompanying notes to consolidated financial statements.

CENTURYLINK, INC.
CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

	As of June 30, 2016	As of December 31, 2015
	(Dollars in millions and shares in thousands)	
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$191	126
Accounts receivable, less allowance of $160 and $152	1,972	1,943
Other	628	581
Total current assets	2,791	2,650
NET PROPERTY, PLANT AND EQUIPMENT		
Property, plant and equipment	39,763	38,785
Accumulated depreciation	(21,869)	(20,716)
Net property, plant and equipment	17,894	18,069
GOODWILL AND OTHER ASSETS		
Goodwill	20,766	20,742
Customer relationships, less accumulated amortization of $6,104 and $5,648	3,472	3,928
Other intangible assets, less accumulated amortization of $1,901 and $1,798	1,506	1,555
Other, net	689	660
Total goodwill and other assets	26,433	26,885
TOTAL ASSETS	$47,118	47,604
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Current maturities of long-term debt	$1,451	1,503
Accounts payable	1,067	968
Accrued expenses and other liabilities		
Salaries and benefits	562	602
Income and other taxes	505	318
Interest	258	250
Other	272	220
Advance billings and customer deposits	727	743
Total current liabilities	4,842	4,604
LONG-TERM DEBT	18,165	18,722
DEFERRED CREDITS AND OTHER LIABILITIES		
Deferred income taxes, net	3,625	3,569
Benefit plan obligations, net	5,390	5,511
Other	1,111	1,138
Total deferred credits and other liabilities	10,126	10,218
COMMITMENTS AND CONTINGENCIES (Note 8)		
STOCKHOLDERS' EQUITY		
Preferred stock—non-redeemable, $25.00 par value, authorized 2,000 shares, issued and outstanding 7 and 7 shares	—	—
Common stock, $1.00 par value, authorized 1,600,000 and 1,600,000 shares, issued and outstanding 545,924 and 543,800 shares	546	544

Additional paid-in capital	15,205	15,178
Accumulated other comprehensive loss	(1,881)	(1,934)
Retained earnings	115	272
Total stockholders' equity	13,985	14,060
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$47,118	47,604

See accompanying notes to consolidated financial statements.

5

CENTURYLINK, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Six Months Ended June 30,	
	2016	2015
	(Dollars in millions)	
OPERATING ACTIVITIES		
Net income	$432	335
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,963	2,088
Impairment of assets	1	8
Deferred income taxes	21	53
Provision for uncollectible accounts	96	84
Net long-term debt issuance costs and premium amortization	—	(3)
Share-based compensation	40	38
Changes in current assets and liabilities:		
Accounts receivable	(125)	(51)
Accounts payable	74	(112)
Accrued income and other taxes	208	120
Other current assets and liabilities, net	(64)	(50)
Retirement benefits	(28)	(19)
Changes in other noncurrent assets and liabilities, net	(35)	(11)
Other, net	18	1
Net cash provided by operating activities	2,601	2,481
INVESTING ACTIVITIES		
Payments for property, plant and equipment and capitalized software	(1,264)	(1,272)
Cash paid for acquisitions	(24)	(4)
Proceeds from sale of property	11	26
Other, net	(2)	(8)
Net cash used in investing activities	(1,279)	(1,258)
FINANCING ACTIVITIES		
Net proceeds from issuance of long-term debt	1,215	594
Payments of long-term debt	(1,464)	(506)
Net payments on credit facility and revolving line of credit	(410)	(405)
Dividends paid	(586)	(609)
Net proceeds from issuance of common stock	3	9
Repurchase of common stock and shares withheld to satisfy tax withholdings	(15)	(277)
Other, net	—	(2)
Net cash used in financing activities	(1,257)	(1,196)
Net increase in cash and cash equivalents	65	27
Cash and cash equivalents at beginning of period	126	128
Cash and cash equivalents at end of period	$191	155
Supplemental cash flow information:		
Income taxes paid, net	$(21)	(41)
Interest paid (net of capitalized interest of $24 and $29)	$(660)	(654)

See accompanying notes to consolidated financial statements.

6

CENTURYLINK, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(UNAUDITED)

	Six Months Ended June 30,	
	2016	2015
	(Dollars in millions)	
COMMON STOCK		
Balance at beginning of period	$544	569
Issuance of common stock through dividend reinvestment, incentive and benefit plans	2	1
Repurchase of common stock	—	(7)
Balance at end of period	546	563
ADDITIONAL PAID-IN CAPITAL		
Balance at beginning of period	15,178	16,324
Issuance of common stock through dividend reinvestment, incentive and benefit plans	3	7
Repurchase of common stock	—	(247)
Shares withheld to satisfy tax withholdings	(14)	(17)
Share-based compensation and other, net	38	40
Dividends declared	—	(211)
Balance at end of period	15,205	15,896
ACCUMULATED OTHER COMPREHENSIVE LOSS		
Balance at beginning of period	(1,934)	(2,017)
Other comprehensive income	53	58
Balance at end of period	(1,881)	(1,959)
RETAINED EARNINGS		
Balance at beginning of period	272	147
Net income	432	335
Dividends declared	(589)	(395)
Balance at end of period	115	87
TOTAL STOCKHOLDERS' EQUITY	$13,985	14,587

See accompanying notes to consolidated financial statements.

CENTURYLINK, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(UNAUDITED)

References in the Notes to "CenturyLink," "we," "us" and "our" refer to CenturyLink, Inc. and its consolidated subsidiaries, unless the content otherwise requires and except in Note 2, where such references refer solely to CenturyLink, Inc.

(1) Basis of Presentation

General

We are an integrated communications company engaged primarily in providing an array of services to our residential and business customers. Our communications services include local and long-distance voice, broadband, Multi-Protocol Label Switching ("MPLS"), private line (including special access), Ethernet, colocation, hosting (including cloud hosting and managed hosting), data integration, video, network, public access, Voice over Internet Protocol ("VoIP"), information technology and other ancillary services.

Our consolidated balance sheet as of December 31, 2015, which was derived from our audited consolidated financial statements, and our unaudited interim consolidated financial statements provided herein have been prepared in accordance with the instructions for Form 10-Q. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to rules and regulations of the Securities and Exchange Commission ("SEC"); however, in our opinion, the disclosures made are adequate to make the information presented not misleading. We believe that these consolidated financial statements include all normal recurring adjustments necessary to fairly present the results for the interim periods. The consolidated results of operations for the first six months of the year are not necessarily indicative of the consolidated results of operations that might be expected for the entire year, and the net cash provided by operating activities for the first six months of the year, in particular, may not be indicative of the net cash that will be provided by operating activities in the last six months of the year. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and the notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015.

The accompanying consolidated financial statements include our accounts and the accounts of our subsidiaries. Intercompany amounts and transactions with our consolidated subsidiaries have been eliminated.

To simplify the overall presentation of our consolidated financial statements, we report immaterial amounts attributable to noncontrolling interests in certain of our subsidiaries as follows: (i) income attributable to noncontrolling interests in other income, net, (ii) equity attributable to noncontrolling interests in additional paid-in capital and (iii) cash flows attributable to noncontrolling interests in other, net financing activities.

We pay dividends out of retained earnings to the extent we have retained earnings on the date the dividend is declared. If the dividend is in excess of our retained earnings on the declaration date, then the excess is drawn from our additional paid-in capital.

We reclassified certain prior period amounts to conform to the current period presentation, including the categorization of our revenues and our segment reporting. See Note 7—Segment Information for additional information. These changes had no impact on total operating revenues, total operating expenses or net income for any period.

Connect America Fund

In 2015, we accepted funding from the Federal Communications Commission's ("FCC") Connect America Fund ("CAF") of approximately $500 million per year for six years to fund the deployment of voice and broadband capable infrastructure for approximately 1.2 million rural households and businesses in 33 states under the CAF Phase 2 high-cost support program. The funding from the CAF Phase 2 support program in these 33 states will substantially supplant funding from the interstate Universal Service Fund ("USF") high-cost program that we previously utilized to support voice services in high-cost rural markets. In late 2015, we began receiving these support payments from the FCC under the new CAF Phase 2 support program, which included monthly support payments at a higher rate than under the interstate USF support program. We recorded $52 million and $104 million more in revenue for the three and six months ended June 30, 2016, respectively, than in the comparable periods for 2015 with respect to our 33 states. We received a substantial one-time cumulative catch-up payment related to the first half of 2015 from the FCC in the third quarter of 2015, and, as a result, we do not expect funding from the CAF Phase 2 support program to materially change our other operating revenues for the full year 2016 when compared to the full year 2015.

Recent Accounting Pronouncements

Financial Instruments

On June 16, 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2016-13, "Measurement of Credit Losses on Financial Instruments" ("ASU 2016-13"). The primary impact of ASU 2016-13 for us is a change in the model for the recognition of credit losses related to our financial instruments from an incurred loss model, which recognized credit losses only if it was probable that a loss had been incurred to an expected loss model, which requires our management team to estimate the total credit losses expected on the portfolio of financial instruments. We are currently reviewing the requirements of the standard and evaluating the impact on our consolidated financial statements.

We are required to adopt the provisions of ASU 2016-13 effective January 1, 2020, but could elect to early adopt the provisions as of January 1, 2019. We expect to recognize the impacts of adopting ASU 2016-13 through a cumulative adjustment to retained earnings as of the date of adoption.

Share-based Compensation

On March 30, 2016, the FASB issued ASU 2016-09, “Improvement to Employee Share-Based Payment Accounting” (“ASU 2016-09”). ASU 2016-09 modifies the accounting and associated income tax accounting for share-based compensation in order to reduce the cost and complexity associated with current generally accepted accounting principles. ASU 2016-09 is effective for us as of January 1, 2017, but early adoption may be elected. ASU 2016-09 includes different transition requirements for the different changes implemented, including some provisions which allow retrospective application. We have not determined when we will implement this standard or if we will retrospectively apply the requirements when allowed.

The primary provisions of ASU 2016-09 that we expect will affect our financial statements are: 1) a reclassification of the tax effect associated with the difference between the expense recognized for share-based payments and the associated tax deduction from additional paid-in capital to income tax expense; 2) a reclassification of the tax effect associated with the difference between compensation expense and associated deduction from financing cash flow to operating cash flow; and 3) an optional accounting policy election to account for forfeitures of share-based payment grants as they occur as opposed to our current policy of estimating the forfeitures on the grant date. These provisions would not have had a material impact on our previously issued financial statements; however, this is not necessarily representative of future impacts. Adoption of ASU 2016-09 may increase the volatility of income tax expense and cash flow from operating activities.

Leases

On February 25, 2016, the FASB issued ASU 2016-02, “Leases” (“ASU 2016-02”). The core principle of ASU 2016-02 will require lessees to present right-of-use assets and lease liabilities on their balance sheets for operating leases, which are currently not reflected on their balance sheets.

ASU 2016-02 is effective for annual and interim periods beginning January 1, 2019. Early adoption of ASU 2016-02 is permitted. Upon adoption of ASU 2016-02, we are required to recognize and measure leases at the beginning of the earliest period presented in our consolidated financial statements using a modified retrospective approach. The modified retrospective approach includes a number of optional practical expedients that we may elect to apply. We have not yet decided when we will adopt ASU 2016-02 or which practical expedient options we will elect. We are currently evaluating and assessing the impact ASU 2016-02 will have on us and our consolidated financial statements. As of the date of this report, we cannot provide any estimate of the impact of adopting ASU 2016-02.

Revenue Recognition

On May 28, 2014, the FASB issued ASU 2014-09, “Revenue from Contracts with Customers” (“ASU 2014-09”). ASU 2014-09 replaces virtually all existing generally accepted accounting principles (“GAAP”) on revenue recognition and replaces them with a principles-based approach for determining revenue recognition using a new five step model. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 also includes new accounting principles related to the deferral and amortization of contract acquisition and fulfillment costs. We currently do not defer any contract acquisition costs and we defer contract fulfillment costs only up to the extent of any revenue deferred.

On July 9, 2015, the FASB approved the deferral of the effective date of ASU 2014-09 by one year until January 1, 2018, which is the date we plan to adopt this standard. ASU 2014-09 may be adopted by applying the provisions of this standard on a retrospective basis to the periods included in the financial statements or on a modified retrospective basis which would result in the recognition of a cumulative effect of adopting ASU 2014-09 in the first quarter of 2018. We have not yet decided which implementation method we will adopt. We are studying ASU 2014-09 and are assessing the impact this standard will have on us and our consolidated financial statements. We cannot at this time, however, provide any estimate of the impact of adopting ASU 2014-09.

(2) Long-Term Debt and Credit Facilities

Long-term debt, including unamortized discounts and premiums and unamortized debt issuance costs, consisting of borrowings by CenturyLink, Inc. and certain of its subsidiaries, including Qwest Corporation, Qwest Capital Funding, Inc. and Embarq Corporation and its subsidiaries ("Embarq"), were as follows:

	Interest Rates	Maturities	As of June 30, 2016	As of December 31, 2015
			(Dollars in millions)	
CenturyLink, Inc.				
Senior notes	5.150% - 7.650%	2017 - 2042	$8,975	7,975
Credit facility and revolving line of credit[1]	—%	2019	—	410
Term loan	2.220%	2019	347	358
Subsidiaries				
Qwest Corporation				
Senior notes	6.125% - 7.750%	2017 - 2056	7,229	7,229
Term loan	2.220%	2025	100	100
Qwest Capital Funding, Inc.				
Senior notes	6.500% - 7.750%	2018 - 2031	981	981
Embarq Corporation and subsidiaries				
Senior notes	7.995%	2036	1,485	2,669
First mortgage bonds	7.125% - 8.770%	2017 - 2025	232	232
Other	9.000%	2019	150	150
Capital lease and other obligations	Various	Various	441	425
Unamortized discounts, net			(130)	(125)
Unamortized debt issuance costs			(194)	(179)
Total long-term debt			19,616	20,225
Less current maturities			(1,451)	(1,503)
Long-term debt, excluding current maturities			$18,165	18,722

(1) The aggregate amount outstanding on our Credit Facility and revolving line of credit borrowings at December 31, 2015 was $410 million with a weighted-average interest rate of 2.756%. At June 30, 2016, we had no borrowings outstanding under our Credit Facility or revolving line of credit. These amounts change on a regular basis.

New Issuances

In April 2016, CenturyLink, Inc. issued $1 billion aggregate principal amount of 7.5% Notes due in 2024, in exchange for net proceeds, after deducting underwriting discounts and other expenses, of approximately $988 million. All of the 7.5% Notes are unsecured obligations and may be redeemed by CenturyLink, Inc., in whole or in part, on or after January 1, 2024, at a redemption price equal to 100% of the principal amount redeemed plus accrued and unpaid interest to the redemption date. At any time before January 1, 2024, the Notes are redeemable, in whole or in part, at CenturyLink, Inc.'s option, at a redemption price equal to the greater of 100% of the principal amount of the Notes to be redeemed or the sum of the present values of the remaining scheduled payments of principal and interest on the Notes to be redeemed, discounted to the redemption date in the manner described in the Notes, plus accrued and unpaid interest to the redemption date. In addition, at any time on or prior to April 1, 2019, CenturyLink, Inc. may redeem up to 35% of the aggregate principal amount of the Notes at a redemption price of 107.5% of the principal amount thereof, plus accrued and unpaid interest to the redemption date, with the net proceeds of certain equity offerings. Under certain circumstances, CenturyLink, Inc. will be required to make an offer to repurchase the Notes at a price of 101% of the aggregate principal amount plus accrued and unpaid interest to the repurchase date.

In January 2016, Qwest Corporation issued $235 million aggregate principal amount of 7% Notes due 2056, in exchange for net proceeds, after deducting underwriting discounts and other expenses, of approximately $227 million. All of the 7% Notes are unsecured obligations and may be redeemed by Qwest Corporation, in whole or in part, on or after February 1, 2021, at a redemption price equal to 100% of the principal amount redeemed plus accrued and unpaid interest to the redemption date.

Repayments

On June 1, 2016, Embarq Corporation paid at maturity the $1.184 billion principal amount and accrued and unpaid interest due under its 7.082% Notes.

On May 2, 2016, Qwest Corporation paid at maturity the $235 million principal amount and accrued and unpaid interest due under its 8.375% Notes.

Covenants

As of June 30, 2016, we believe we were in compliance with the provisions and covenants contained in our Credit Facility and other material debt agreements.

(3) Severance and Leased Real Estate

Periodically, we have reductions in our workforce and have accrued liabilities for the related severance costs. These workforce reductions resulted primarily from the progression or completion of our post-acquisition integration plans, increased competitive pressures, cost reduction initiatives, process improvements through automation and reduced workload demands due to the loss of customers purchasing certain services.

We report severance liabilities within accrued expenses and other liabilities - salaries and benefits in our consolidated balance sheets and report severance expenses in cost of services and products and selling, general and administrative expenses in our consolidated statements of operations. As noted in Note 7—Segment Information, we do not allocate these severance expenses to our segments.

We have recognized liabilities to reflect our estimates of the fair values of the existing lease obligations for real estate which we have ceased using, net of estimated sublease rentals. Our fair value estimates were determined using discounted cash flow methods. We recognize expense to reflect accretion of the discounted liabilities and periodically we adjust the expense when our actual subleasing experience differs from our initial estimates. We report the current portion of liabilities for ceased-use real estate leases in accrued expenses and other liabilities - other and report the noncurrent portion in deferred credits and other liabilities - other in our consolidated balance sheets. We report the related expenses in selling, general and administrative expenses in our consolidated statements of operations. At June 30, 2016, the current and noncurrent portions of our leased real estate accrual were $8 million and $64 million, respectively. The remaining lease terms range from 0.1 to 9.5 years, with a weighted-average of 8.1 years.

Changes in our accrued liabilities for severance expenses and leased real estate were as follows:

	Severance	Real Estate
	(Dollars in millions)	
Balance at December 31, 2015	$14	80
Accrued to expense	22	2
Payments, net	(23)	(13)
Reversals and adjustments	—	3
Balance at June 30, 2016	$13	72

(4) Employee Benefits

Net periodic (income) expense for our qualified and non-qualified pension plans included the following components:

	Pension Plans			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(Dollars in millions)			
Service cost	$15	20	32	42
Interest cost	107	142	214	283
Expected return on plan assets	(183)	(223)	(367)	(449)
Recognition of prior service (credit) cost	(2)	2	(4)	3
Recognition of actuarial loss	45	42	87	80
Net periodic pension benefit income	$(18)	(17)	(38)	(41)

Net periodic expense (income) for our post-retirement benefit plans included the following components:

	Post-Retirement Benefit Plans			
	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
	(Dollars in millions)			
Service cost	$ 5			